REPORT BY THE

AUDITOR GENERAL

OF CALIFORNIA

THE DEPARTMENT OF INSURANCE NEEDS TO FURTHER IMPROVE AND INCREASE ITS REGULATORY EFFORTS

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Auditor General

June 30, 1987 P-650

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

The Office of the Auditor General presents its report concerning the Department of Insurance's need to conduct more frequent rate examinations of insurance companies and to more promptly process applications from insurance companies seeking to conduct business in California.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

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RESULTS IN BRIEF

Although it has improved its rate examination procedures since March 1985, the Department of Insurance (department) needs to take further steps to ensure that it adequately oversees the underwriting and rate-setting practices of insurance companies. In addition, the department needs to take steps to more quickly process applications from insurance companies seeking to do business in California. During our audit, we noted the following specific conditions:

- About one-half of approximately 700 property/casualty insurance companies subject to rate examination have never been examined;

- From March 1985 through February 28, 1987, the department completed examinations of 63 of the approximately 700 property/casualty insurance companies subject to examination;

- The department has only once taken formal disciplinary action against an insurance company as a result of a rate examination; and

- Thirteen of 20 applications that we reviewed were unnecessarily delayed beyond the department's 30-day processing goal for periods ranging from 13 days to almost three years.

BACKGROUND

The State of California will spend approximately $26.1 million in fiscal year 1986-87 to operate the department, which is responsible for protecting policyholders in California by regulating the insurance industry. As part of its effort to carry out these responsibilities, the department conducts examinations of insurance companies to ensure that the underwriting and rate-setting

practices of insurance companies comply with the law and that the rates charged to policyholders are not excessive, inadequate, or unfairly discriminatory. The department also issues certificates of authority to insurance companies and licenses to agents and brokers to ensure that they are qualified to do business in California.

PRINCIPAL FINDINGS

The Department of Insurance Needs To Further Improve Its Rate Examination Procedures

The department's goal is to examine property/casualty insurance companies every five years. In September 1985, the department estimated that approximately one-half of the property/casualty companies subject to examination had never been examined. From March 1985 to February 28, 1987, the department completed examinations of 63 of the 700 companies, but only 6 of the 63 were companies that had not been examined before. Consequently, approximately one-half of the property/casualty companies still have never been examined. Because the law does not require insurance companies to report their rates to the department, the department cannot evaluate whether these rates are appropriate unless it conducts the rate examinations.

When the department does conduct rate examinations, it can identify problems that can be corrected to protect the consumer. The department has not conducted more frequent rate examinations primarily because, in the past, it has not had a sufficient number of experienced staff. Currently, the department estimates that it has enough staff to meet its examination goal.

In addition, the department implemented a follow-up examination procedure because it found that insurance companies do not always correct the deficiencies it finds. However, the department only once has taken formal disciplinary action against an insurance company as a result of a rate examination. Yet

in 6 of 18 examinations, we found eight recurring problems. The department has not taken more disciplinary action against insurance companies because, according to department management, the threat of department action will cause insurance companies to voluntarily correct the deficiencies found.

The Department of Insurance Has Been Slow To Process Companies' Applications

To protect the consumer, the department conducts a comprehensive review of the legal and financial arrangements of all applicant companies to ensure that only qualified insurance companies do business in California. After an applicant company submits any information during the review process, the department attempts to respond within 30 days. We reviewed 20 of over 280 applications that the department was processing from February 1985 through October 1986. Thirteen (65 percent) of the 20 applications were delayed by the department's Legal Division. In these 13 cases, the department exceeded its 30-day goal by periods ranging from 13 days to almost three years. In the department's Financial Analysis Division, 4 (20 percent) applications were delayed. These delays exceeded the 30-day goal by periods ranging from 20 days to almost eight months. When insurance companies have to wait for long periods to enter the California marketplace, the resulting effects can be limited competition and limited availability of insurance.

The delays in processing applications occurred primarily because both the Legal and the Financial Analysis divisions were significantly understaffed for much of the period covered by our review. However, as of December 1986, the department had filled most of its vacant positions in the Legal Division's Corporate Affairs Bureau and the Financial Analysis Division's Financial Analysis Bureau.

Another factor contributing to the delays was a backlog of applications that developed because the number of applications submitted each year

increased substantially between 1976 and 1982. Further, the department does not consider processing applications as high a priority as its other work of reviewing companies already doing business in California.

The Department of Insurance Has Improved Its Regulation of the Insurance Industry

The department has taken action to improve its regulatory activities. From March 1979 through February 1985, the department had conducted "mono-line" examinations, which evaluated the rate for only one line of insurance at a time. However, in March 1985, the department resumed "multi-line" rate examinations, which evaluate the rating practices that a company applies to its various lines of insurance. Also, the department has requested an additional five examiner positions to increase the number of rate examinations it can conduct. Further, the department has begun scheduling follow-up examinations in certain instances.

Finally, to more promptly review companies' applications to do business in California, the department has recently filled most of the attorney and examiner vacancies in the Legal and Financial Analysis divisions.

RECOMMENDATIONS

To further improve its regulatory effectiveness, the Department of Insurance should take the following actions:

- Ensure that it has enough staff to effectively oversee the underwriting and rate-setting practices of the insurance industry and to process the applications of insurance companies. If the department determines that it needs additional staff, the cost of the increased staff can be recovered through fees paid by the insurance industry;

- Conduct more frequent rate examinations to ensure that insurance companies are complying with the law. The department should also take formal disciplinary action whenever an insurance company willfully fails to correct deficiencies within a specified time; and

- Develop written policies, procedures, and guidelines to ensure more consistency and effectiveness in the department's examination of insurance companies' rates.

AGENCY COMMENTS

The Business, Transportation and Housing Agency reported that the department is taking steps to implement the report's recommendations.

INTRODUCTION

The Department of Insurance (department) is responsible for regulating insurance companies, agents, and brokers and for protecting policyholders in California. As part of its effort to carry out these responsibilities, the department conducts rating examinations of insurance companies to ensure that their underwriting and rating practices comply with the provisions of the California Insurance Code and that the rates that companies charge to policyholders are neither excessive, inadequate, nor unfairly discriminatory. The department also issues certificates of authority to insurance companies and licenses to agents and brokers.

Currently, approximately 1,400 insurance companies are authorized to do business in California. The department estimates that these companies write approximately $30 billion in premiums from policyholders annually. The department also licenses approximately 330 grants and annuities societies and underwritten title companies.

The insurance industry is almost entirely regulated by the states, rather than by the federal government. Federal law, specifically the McCarran-Ferguson Act of 1945, exempts the insurance industry from anti-trust laws in those states where the state regulates the industry sufficiently to ensure competition.

Program Administration

The department regulates the insurance industry from its offices in San Francisco, Los Angeles, San Diego, and Sacramento. For fiscal year 1986-87, the department had 461 authorized positions and a budget of $26.1 million.

The Field Operations Bureau, within the Consumer Affairs Division, conducts rate examinations primarily of property/casualty insurance companies, of which the department estimates there are approximately 700 in the State. In 1986, the Field Operations Bureau completed 16 rate examinations of 45 insurance companies. At year end, the department was in the process of conducting an additional 14 examinations of 30 companies. Because separate companies can constitute one insurance group, the department can review several insurance companies in one examination.

The department's Corporate Affairs Bureau, within the Legal Division, is responsible for issuing certificates authorizing companies to transact insurance business in California. The department issues certificates of authority to those applicant companies that have successfully completed the department's review process. The Legal Division is assisted in this review by the department's Financial Analysis Bureau within the Financial Analysis Division. To ensure that only qualified companies are allowed to transact insurance business in the State, the department conducts a detailed review of the legal and

financial arrangements of every applicant company. In calendar year 1986, the department received applications from 59 insurance companies and issued 44 certificates of authority.

In addition, to protect the public from economic loss caused by the misrepresentation, dishonesty, or incompetence of any insurance agent or broker, the License Bureau determines the eligibility of all applicants for agents' and brokers' licenses. The License Bureau also maintains and updates license information for all current licensees. Although the department's 1986 statistics have not been published, the chief of the License Bureau estimates that the department issued approximately 55,500 new licenses in 1986. As of January 4, 1987, there were 202,766 active licenses issued to agents and brokers to transact insurance in California.

Budgetary Information for Fiscal Year 1986-87

The department is funded primarily by license fees and fees that the department charges the insurance companies for examinations. In the governor's proposed budget for fiscal year 1987-88, the department projects that revenues for fiscal year 1986-87 will be \$25.7 million. The department's projected expenditures for fiscal year 1986-87 total \$26.1 million. The department also projected in the governor's proposed budget for fiscal year 1987-88 that it would have approximately \$3 million in fiscal year 1986-87 in its reserve fund in case of economic uncertainties.

SCOPE AND METHODOLOGY

The purpose of our review was to evaluate the department's performance of its rate examination responsibilities and its promptness in processing applications from insurance companies seeking to do business in the State. In addition, we attempted to determine whether California's entry requirements for companies seeking a license were more restrictive than those of other states. We also evaluated the department's procedures for ensuring that agents and brokers applying for licenses do not have criminal histories that would preclude their eligibility for licenses. Finally, because it has been an issue of recent controversy, we developed an overview, which is presented in the appendix, of the financial position of the property/casualty sector of the insurance industry from 1975 through 1986. The overview shows that during this 12-year period the property/casualty insurance industry had overall losses in only 2 years and, in 1986, realized an overall profit nationwide of approximately $6.8 billion.

To assess the department's performance of its rate examination activities, we reviewed each of the 23 examination reports that the Field Operations Bureau had completed from March 1985, when it resumed multi-line examinations, through February 28, 1987.* Since the department had conducted prior examinations for 18 of the 23

*The department had actually completed and "filed" 21 examinations; but for another 2, the department had finished the review, written the report, and was waiting for a response from the insurance company. We included these 2 additional examinations in our analysis.

examinations, we also reviewed each of the 18 prior examinations to determine whether the insurance companies had recurring problems. We also examined the department's follow-up activities when the department found problems during an examination, and we reviewed all formal disciplinary actions taken by the department as a result of problems identified during rate examinations.

To assess the department's promptness in processing applications from insurance companies, we selected a sample of 20 applications from over 280 that were being processed by the department from February 1985 through October 1986. In addition, we traced the course of each of the 20 applications from the time it arrived at the department through March 25, 1987.

As part of our review of the application process, we compared California's entry requirements for companies seeking authorization to do business with the entry requirements of the states of New York, Illinois, Texas, and Florida, whose market volumes are the most comparable to California's. Based on our review and interviews with representatives of the National Association of Insurance Commissioners, the National Association of Independent Insurers, and the Insurance Services Organization, we do not conclude that California's entry requirements are significantly more restrictive than those of the other states we selected for comparison. Furthermore, the chief counsel and assistant chief counsel of the department's Legal Division have stated

that California's entry requirements are, for the most part, specified in the California Insurance Code and are intentionally comprehensive to protect the California consumer.

To determine whether the department ensures that agents and brokers who apply for licenses or who already have licenses do not have criminal histories that would preclude them from being licensed to do business in California, we reviewed the department's procedures for licensing agents and brokers and for updating criminal history information on licensees. The department screens all applicants through the Department of Justice. From a sample of 19 applicants and licensees, we reviewed reports of criminal information that the department received from the Department of Justice. In each case, the department followed standard procedures for screening, investigating, and documenting the criminal information. As a result, we conducted no further audit work in this area.

AUDIT RESULTS

I

THE DEPARTMENT OF INSURANCE NEEDS TO FURTHER IMPROVE ITS RATE EXAMINATION PROCEDURES

Since March 1985, the Department of Insurance (department) has made improvements in its rate examination procedures; however, the department needs to take further steps to ensure that it adequately oversees the underwriting and rate-setting practices of insurance companies. Specifically, the department needs to conduct more frequent rate examinations.

In September 1985, the department estimated that approximately one-half of the property/casualty insurance companies subject to examination had never been examined. From March 1985 to February 28, 1987, the department completed rate examinations of 63 (9 percent) of the approximately 700 property/casualty companies, but only 6 of the 63 were companies that had not been examined before. Consequently, about one-half of the approximately 700 property/casualty companies still have never been examined. Finally, the department has taken only one formal disciplinary action against an insurance company as a result of a rate examination.

The California Insurance Code does not require insurance companies to report their rates to the department. Consequently, if

the department does not conduct a rate examination of an insurance company, the department, in most cases, cannot know what rates the company is charging. The department, therefore, cannot effectively protect the California consumer because it cannot ensure that companies' rates are not excessive, inadequate, or unfairly discriminatory. Additionally, if the department does not take disciplinary action when necessary, the department cannot ensure that the deficiencies it finds are corrected.

Rate Regulation

Some states regulate the rates that insurance companies charge consumers by requiring that the proposed rates be submitted to their insurance departments before the rates become effective. However, California has a competitive rating law that allows insurance companies to set their own rates for most lines of property/casualty insurance. The purpose of this law, as outlined in the California Insurance Code, is to permit and encourage competition among insurance companies. Furthermore, the law does not require insurance companies to report their rates to the department. The law does, however, authorize the insurance commissioner to direct the department to conduct rate examinations of any authorized insurance company and to take corrective action against any company that is using a rate that is excessive, inadequate, or unfairly discriminatory.

We found several examples of how rate examinations protect consumers. For instance, one company was charging farmers a 10 percent surcharge to inspect property before issuing the policy. However, the department determined that the surcharge was part of the company's business costs, and the company subsequently agreed to discontinue the inspection surcharge. In another examination, the department reviewed a sample of policies and found over $36,000 in overcharges to policyholders. The company agreed to refund these overcharges and to take steps to reduce its error rate. In another instance, a company was going to cancel over 500 policies at mid-term. After meeting with the department, the company agreed to renew coverage for all policyholders who wanted these policies for the remainder of the contract term, which was three years. Finally, one company increased its rate by 80 percent. The department considered this increase unjustified, and the company subsequently reduced the increase to 55 percent.

Recent Improvements

Since March 1985, the department has made improvements in its rate examination procedures. From March 1979 through February 1985, the department conducted only "mono-line" examinations of insurance companies. Although an insurance company may have provided multiple lines or types of insurance, such as automobile and homeowners' insurance, the department, in its mono-line examinations, reviewed only one line of insurance per examination. However, the department found

mono-line examinations to be less effective than it had anticipated. Consequently, in March 1985, the department again began conducting "multi-line" examinations.

Furthermore, when the department was conducting mono-line examinations, most of the work was done in the department offices rather than at the insurance companies. In March 1985, the department examiners again began conducting the examinations at the offices of the insurance companies.

Additionally, in March 1985, the department for the first time developed a systematic follow-up procedure to ensure that insurance companies correct any deficiencies the department finds. Under the new procedure, if the department finds a significant problem or a recurrence of a problem that was identified during a prior examination, the department will schedule that company for a follow-up examination approximately 12 months after the completion of the most recent examination. Between March 1985 and February 1987, the department conducted two follow-up examinations and scheduled another six. According to the chief of the Field Operations Bureau, the department developed this policy because it found that insurance companies were not always correcting deficiencies. Although the department does not have any written policy on follow-ups, the department did respond to our request for a written statement of this policy.

Infrequent Rate Examinations

Despite the improvements made in the rate examination procedures, the department needs to take further steps to ensure that insurance companies are charging appropriate rates to their policyholders. One step is to increase the number of rate examinations. The department does not have any written policy on the frequency of rate examinations, but, according to the chief of the Consumer Affairs Division and the chief of the Field Operations Bureau, the department's goal is to examine insurance companies once every five years. A company is selected for examination according to the amount of premium written, the length of time since the last examination, and the number of complaints received from consumers.

In September 1985, the department estimated that approximately one-half of the property/casualty insurance companies had never been examined. Between March 1985 and February 28, 1987, the department completed examinations of 63 (9 percent) of the approximately 700 companies subject to rate examination, but only 6 of the 63 were companies that had not been examined before. Consequently, about one-half of the approximately 700 property/casualty insurance companies still have never been examined. Of the top 70 (10 percent) companies in the State in terms of premium earned, within the last twenty years 5 (7 percent) have not been examined and another 3 (4 percent) have had

only mono-line examinations.* Within the last five years, of the top 70 companies, 20 (29 percent) have had multi-line examinations, 31 (44 percent) have had only mono-line examinations, and 19 (27 percent) have not been examined at all. During the last ten years, 42 (60 percent) of the 70 companies have had multi-line examinations, 17 (24 percent) have had only mono-line examinations, and 11 (16 percent) have not been examined at all. In 1985, these 70 companies earned over $13.8 billion in premiums, 70 percent of the property/casualty insurance premium earned in California. Table 1 shows the number of rate examinations the department conducted during the last twenty years of the top 70 (10 percent) companies in the State.

TABLE 1

RATE EXAMINATIONS OF THE TOP 70 INSURANCE COMPANIES JANUARY 1967 THROUGH DECEMBER 1986

	1982-86 (5 years)	1977-86 (10 years)	1972-86 (15 years)	1967-86 (20 years)
Multi-line examinations	20 (29%)	42 (60%)	56 (80%)	62 (89%)
Mono-line examinations only	31 (44%)	17 (24%)	6 (9%)	3 (4%)
No examinations	19 (27%)	11 (16%)	8 (11%)	5 (7%)
Total	70	70	70	70

*Mono-line examinations reviewed only an isolated part of a company's operation. The department was not satisfied with the effectiveness of the mono-line examinations, which is why it shifted back to multi-line examinations in 1985.

When the department does not examine companies for such long periods of time, it cannot effectively protect the California consumer by ensuring that the companies are charging appropriate rates. Also, as the department stated in a recent budget change proposal for additional staff to conduct the rate examinations, "Because property/casualty insurers are examined at infrequent intervals, companies are able to continue improper practices for long periods of time." For example, one company, which was admitted in California in 1981, was examined for the first time in November 1986, and the department had enough concerns about the adequacy of the company's rates that the department scheduled the company for a follow-up examination. In another examination, a company was cited for errors on 34 percent of its policies on commercial automobiles. The department noted that the company was cited for the same types of errors in an examination in 1976, 9 years earlier. In another examination we reviewed, the department cited the company for a high error rate, again for the same types of errors found in an examination in 1975, over 11 years earlier.

The department has not conducted more frequent rate examinations because in the past it has not had enough experienced staff. According to the chief of the Field Operations Bureau, several years ago the department hired examiners who were not experienced in the insurance industry. According to the chief, at one time, 8 of 16 examiners were inexperienced. The chief further stated that if an examiner has no insurance background, it will take two to three years

for that person to become a qualified examiner, and even if the person has had experience within the insurance industry, it will take one year of training to become qualified. Consequently, because the people hired were not experienced examiners, for several years the department has had to assign two to three examiners to each examination: one to supervise and train and one or two to be trained. As these staff are becoming more competent, according to the chief of the bureau, he is able to assign fewer staff per examination, enabling the department to conduct more examinations.

Additionally, according to the chief of the Field Operations Bureau, during 1986, six of the field examiners were temporarily reassigned to handle a backlog of consumer complaints in the Rate Administration Bureau. Also, in August 1986, the Field Operations Bureau received five examiner positions for fiscal year 1986-87 only. For fiscal year 1987-88, the department has submitted a budget change proposal to permanently establish the five examiner positions within the Field Operations Bureau. The department estimates that with the additional five examiners, the department could examine insurance companies every 5.5 years. The cost of the additional field examiners could be passed on to insurance companies since the department charges the companies that are examined the cost of the examination.

Only One Formal Disciplinary Action

To discipline insurance companies that willfully do not correct deficiencies noted by the department, Section 1858 et seq. of the California Insurance Code allows the department, through the insurance commissioner, to take the following disciplinary actions: to hold a public hearing; to suspend or revoke a company's certificate of authority; and to fine an insurance company. For example, the department can fine a company from $1,000 per day up to a total fine of $30,000. According to the chief of the Field Operations Bureau, the department began conducting rate examinations in 1949; in 1985, because it found that insurance companies were not correcting deficiencies, the department instituted a follow-up examination policy. However, the department has taken only one formal disciplinary action against an insurance company as a result of a rate examination. In July 1986, the department criticized a company for charging policyholders an inflated penalty when the company cancelled temporary policies at mid-term. The department is currently taking action to suspend the certificate of authority of this insurance company for conducting its business in a "fraudulent way."

According to the chiefs of the Consumer Affairs Division and the Field Operations Bureau, the department holds informal hearings with insurance companies to bring them into compliance. Both chiefs also stated that, generally, the threat of a public hearing is sufficient to bring insurance companies into voluntary compliance. The

insurance commissioner also stated that she believes that most insurance companies will come into compliance voluntarily. However, in 6 of 18 prior examinations reviewed, we found eight instances in which during the second examination the department found the same deficiencies that it had cited in the earlier examination.

The chief of the Consumer Affairs Division stated that, if an insurance company is found to be willfully not complying, the department will take swift action. However, in one rate examination we reviewed, the department notified the company in May 1986 that the company was incorrectly applying a 30 percent surcharge for personal automobile insurance for persons with no prior insurance. Incorrectly applying the surcharge resulted in overpayments by consumers. The department asked the company to stop this practice and to refund the excess premiums collected. In August 1986, representatives of the company requested a meeting with the department to review the issue. The meeting was held in September 1986. At the time of our review on February 26, 1987, we found no evidence that the issue had been resolved. Following our questions on this matter, the department wrote to the representatives of the company on February 26, 1987, requesting confirmation that the problem had been resolved and warning the company of possible disciplinary action if the company did not respond within 15 days. On March 24, 1987, the company wrote to the department and reported that it had discontinued the practice in September 1986. However, there was no evidence that the department was aware of the correction until March 1987, ten months after the deficiency was noted.

Finally, the chiefs of the Consumer Affairs Division, the Field Operations Bureau, and the Legal Division stated that one reason that existing fines have not been used is because they are too small to be effective compared with an insurance company's income. The insurance commissioner is currently proposing legislation that would increase the fines.

CONCLUSION

Although the Department of Insurance has made improvements in its rate examination procedures since March 1985, the department needs to take further steps to ensure that the underwriting and rate-setting practices of insurance companies comply with the law and that companies are not charging policyholders rates that are excessive, inadequate, or unfairly discriminatory.

Specifically, the department needs to conduct more frequent rate examinations. In September 1985, the department estimated that approximately one-half of the property/casualty companies in the State had never been examined. Between March 1985 and February 1987, the department completed rate examinations of 63 (9 percent) of the approximately 700 insurance companies subject to examination, but only 6 of the 63 were companies that had not been examined before. Consequently, approximately one-half of the property/casualty

companies still have never been examined. Finally, although the department has noted that insurance companies do not always correct the deficiencies it finds, the department only once has taken formal disciplinary action against an insurance company as a result of deficiencies found during a rate examination.

The department has not conducted more frequent rate examinations because, in the past, it has not had enough experienced staff. Additionally, from March 1979 through February 1985, the department conducted only mono-line examinations rather than multi-line examinations. Finally, the department has not taken more frequent disciplinary action because, according to department officials, the threat of department actions will cause insurance companies to voluntarily implement corrective measures.

RECOMMENDATIONS

To effectively conduct its rate examination responsibilities, the Department of Insurance should take the following actions:

- Conduct more frequent multi-line rate examinations;

- Determine whether it can implement the above recommendation with existing staff. If it does not have enough staff, the department should determine the staffing level necessary to conduct an effective regulatory program and take the necessary steps to obtain additional staff. The cost of the additional staff can be recovered through the examination fees charged to the insurance companies;

- Take formal disciplinary action whenever an insurance company willfully and within a specified time does not comply with the department's recommendation to correct deficiencies; and

- To provide more consistency in rate examinations, the department should develop in writing the following policies, procedures, and guidelines:

  - The standard for frequency of examinations;

  - A procedure requiring examiners to note in the examination reports whether similar deficiencies were noted in prior examinations; and

  - A policy regarding use of disciplinary actions.

II

THE DEPARTMENT OF INSURANCE HAS BEEN SLOW TO PROCESS APPLICATIONS FROM COMPANIES SEEKING TO DO BUSINESS IN CALIFORNIA

The department delayed the processing of 13 (65 percent) of 20 applications that we reviewed for periods ranging from 13 days to almost 3 years. As a result of these delays, companies have had to wait unnecessarily before being allowed to enter the California marketplace. Such unnecessary waits can restrict competition and limit the availability of insurance to consumers.

Application Review Process

Section 700 of the California Insurance Code prohibits companies from entering the insurance business in California without first being admitted by the department. Interested companies must apply to the department and demonstrate that they are in compliance with the provisions of the code and other laws of the State. When the department is satisfied that a company meets all requirements, the department issues a certificate of authority to the company, allowing the company to do business in the State. During the last three years, the department has issued approximately 43 certificates of authority per year.

To ensure that only qualified insurance companies enter the marketplace, the department has a comprehensive process to review company applications. To begin the admission process, a company must submit a filing fee of $1,770 with the application package. The application is then reviewed by the Corporate Affairs Bureau within the department's Legal Division. This review includes an initial determination of the company's ability to meet the minimum legal requirements stated in the code. For example, the department determines whether the company has sufficient assets to meet the code's minimum requirements for capital and surplus and whether the company has been in the insurance business long enough to meet the code's requirement for minimum time in business.

When the Corporate Affairs Bureau is satisfied that the applicant meets the minimum requirements, the application is forwarded to the department's Financial Analysis Bureau within the Financial Analysis Division. Here the application is given a preliminary financial review to determine if there are any obvious financial deficiencies that would prevent the company from being admitted to the State. Once the Financial Analysis Bureau has reviewed the application, it is sent back to the Corporate Affairs Bureau. These two initial reviews conclude what the department terms the "stage 1" review. If the application has been approved at this stage, the department requests the company to submit a more detailed package of information for the "stage 2" review.

During stage 2, the Corporate Affairs Bureau conducts a more in-depth review of the applicant company. For example, the department reviews the company's articles of incorporation and bylaws, the biographic affidavits of the company's officers, directors, stockholders, and key management staff, and the company's plan of operation. Generally, the legal review at stage 2 is the most time-consuming phase of the review process. Upon completion of the legal review, the application is again sent to the Financial Analysis Bureau for a thorough evaluation of the company's financial condition. When the financial evaluation is completed, the application is returned to the Corporate Affairs Bureau, and a certificate of authority is issued to the company authorizing it to enter the insurance business in this State.

If the application is not approved at any of these stages, it may be denied. Additionally, the company may withdraw its application at any time. If the applicant fails to submit sufficient information for the department to make its determinations during any of the phases of the review process, the department contacts the applicant company and requests the additional information. In fact, for most applications, the department contacts the applicant numerous times to request additional information and clarification.

When a new insurance company is being formed within California, that company must first apply to the department for a securities permit to raise the capital necessary to begin business.

Once an extensive review of the company is conducted by the Corporate Affairs Bureau and the Financial Analysis Bureau, the securities permit may be approved. Following the issuance of the securities permit, the company must first raise the necessary capital to begin business and may then apply for the certificate of authority. The department then does a final examination of the company's application.

Because each application is different, the department does not have a standard amount of time in which it tries to process applications and issue certificates of authority. In addition, the department does not report statistics on the average length of time required to process applications. The states of Florida, Illinois, New York, and Texas, whose market volumes are the most comparable to California's, reported total processing times ranging from 3.5 months to two years. However, we did not determine the extent of the review process conducted by these other states nor their budget and staffing levels for processing applications.

Although the department does not have a standard for total processing time, the department does attempt to respond to each submission of information by the applicant within 30 calendar days. For example, when the company first submits its application, the department attempts to review it within 30 days to determine if additional information is needed. Once the additional information is received, the department again attempts to process the application or respond to the company within 30 days after receiving the information.

We used this 30-day goal to evaluate the promptness of the department's processing of applications. We selected a sample of 20 applications from over 280 that the department was reviewing from February 1985 through October 1986. We traced the course of each of the 20 applications from the time it arrived at the department through March 25, 1987. If the department exceeded its 30-day goal in responding to an applicant's submission of information, we determined the reason. Often delays occurred because the department was waiting for additional information from the company. We did not include in our analysis these delays caused by companies. Consequently, we counted only delays caused by the department. Further, of these department delays, we included only those for which the department had no explanation or those for which the department explained that it had, for example, either mislaid the application or did not have enough staff to meet the workload. Furthermore, in counting the length of delays, we included only the time that exceeded the department's 30-day goal. For example, if the department did not respond until 49 days after the department received the information from the applicant, we counted it as a 19-day delay--30 days plus 19. Additionally, we did not count a delay if it exceeded the 30-day goal by only 6 days or less.

Delays in Processing Applications

The department met its 30-day goal in 7 (35 percent) of the 20 applications that we reviewed. For the other 13 (65 percent)

applications, the department exceeded its 30-day goal in 21 instances. The delays caused by the department ranged from 13 days to almost 3 years. The department took an average of almost 2.5 years to process 11 of the 20 applications that we reviewed. The total time to process these 11 completed applications ranged from 242 days to 4.5 years. The 9 other applications were still in the review process as of March 25, 1987. We noted other instances when the department took over 7 years to process applications. According to the assistant chief counsel, who supervises the Corporate Affairs Bureau, these applications took over 7 years to process because the department had serious concerns about the qualifications of the applicants.

In the Corporate Affairs Bureau, in 17 instances on 13 of the 20 applications, the department was the cause of exceeding its 30-day goal in responding to an application. The delays occurred between November 1983 and December 1986 and ranged from 13 days to almost 3 years. The average delay was over 4.5 months if the extreme 3-year delay is deleted from the average; otherwise, the average delay was over 6 months. In the Financial Analysis Division, 4 (20 percent) of 20 applications were delayed. These delays occurred between November 1982 and September 1986 and ranged from 20 days to almost 8 months. The average delay was 2.9 months. Table 2 lists the number of days that the 13 of 20 cases we reviewed were delayed by the department through March 25, 1987.

TABLE 2

NUMBER OF DAYS THE DEPARTMENT OF INSURANCE EXCEEDED ITS GOAL IN RESPONDING TO AN APPLICATION

Company Number	Application Filing Date	Corporate Affairs Bureau Delay (Days)	Financial Analysis Division Delay (Days)	Date of Application Approval, Denial, or Withdrawal	Total Days Delayed	Total Processing (Days)
1	08/23/82	732	20	02/24/87	752	1,646
2	10/07/82	95		11/20/86	95	1,505
3	05/26/83	57		05/22/85	57	727
4	08/16/83	1,010		---	1,010	---
5	09/05/84	139		---	139	---
6	09/18/84	19	40	12/07/86	59	810
7	10/09/84	129		---	129	---
8	11/02/84	125	49	---	174	---
9	12/04/84	385		12/16/86	385	742
10	03/12/85	127		---	127	---
11	05/06/85	107	232	---	233*	---
12	05/13/85	183		03/23/87	183	679
13	07/03/85	122		08/29/86	122	422

--- The department was still processing these applications as of March 25, 1987.

*This case was delayed simultaneously in the Corporate Affairs Bureau and the Financial Analysis Division. Consequently, the total days delayed reflect the actual days delayed and are not a sum of the individual delays.

Because of these delays, companies had to wait unnecessarily to do business in California. For example, one company's application was delayed four times in the Corporate Affairs Bureau for a total of 24 months because there were not enough experienced staff available to process the applications and, according to the attorney working on the application, it "fell through the cracks." That same application was delayed in the Financial Analysis Bureau for an additional 20 days

because staff were too busy to process it. Another company's application was delayed in the Corporate Affairs Bureau for approximately 4 months without any explanation, and it was also delayed in the Financial Analysis Bureau for an additional 1.5 months because the bureau did not have enough experienced staff.

In addition to making these companies wait unnecessarily before being allowed to enter the California marketplace, these delays can restrict competition within the State and limit the availability of insurance to the consumer. Further, the intent of the California insurance law is to encourage competition. In a previous request to increase staff to maintain program efficiency, the department protested that a backlog of applications would "stifle competition and prevent innovative responses to rapidly-changing financial conditions." The department also noted that if insurance companies have to wait too long to be admitted to the State, the development of new products would be hindered and the availability of insurance to the consumer could be limited.

Causes of Delays

Applications were delayed primarily because the department did not have enough staff to handle its workload. However, the delays were also caused by an increased backlog of applications and the fact that the department does not consider the processing of applications as its highest priority.

Staff Shortages

Between January 1984 and June 1986, the Corporate Affairs Bureau had three extended periods when its vacancy rate for attorneys was 33 percent, 30 percent, and 40 percent, respectively. From January through July 1984, three of nine authorized attorney positions were vacant. From October through December 1985, three of ten authorized attorney positions were vacant. Finally, from January through June 1986, four of ten attorney positions were vacant. Additionally, from August 1984 through March 1985, an average of two (33 percent) of the bureau's six legal assistant positions were vacant.

The vacancies in 1984 were due partially to hiring freezes. The governor instituted hiring freezes that were in effect from January 1983 through June 1984. The department obtained exemptions from these hiring freezes to fill some of the legal vacancies, but the department was still required to first fill these positions through intradepartment transfers or by hiring from the State Restriction of Appointments (SROA) list of candidates. However, the assistant chief counsel of the Legal Division stated that the department was unable to fill the positions through intradepartment transfers and was unable to find candidates on the SROA list who were qualified and interested in accepting a position with the department.

The vacancies in late 1985 and 1986 were due to several factors. First, according to the personnel officer, the department was

not satisfied with its existing list of legal counsel candidates and decided to create a new list of qualified candidates. The department allowed applicants approximately three months to file and eventually scheduled approximately 300 applicants for interviews for staff counsel and graduate legal assistant positions. The entire process of developing the new list of candidates took approximately six months.

Second, according to the assistant chief counsel and the personnel officer, the department decided to postpone filling the positions until it received the results of a study, which began in September 1985, that was to recommend ways to reorganize and streamline the work of the Legal Division. However, the department did not receive the final report from the consultant hired to conduct the study. According to the insurance commissioner, the consultant did provide some preliminary recommendations, but the insurance commissioner rejected them as inappropriate. Also, because the department hired the consultant as a limited-term employee rather than as an independent contractor, the department had no legal recourse to obtain the final report even though the consultant was paid approximately $28,600 over seven months. When a state agency requires the services of an individual outside the state civil service system, depending upon the circumstances involved, the individual may be hired as either a limited-term employee or an independent contractor. The Department of Insurance hired this particular consultant as a limited-term employee with the approval of the Department of Personnel Administration. However, according to the Policy and Procedures Manual

of the Department of Personnel Administration, if the department had hired this individual as a contractor, the department would have placed him under a contractual obligation to provide the report for a fixed price and within a specified time. Since individual contractors are treated as private entrepreneurs rather than salaried employees, their compensation must be tied to the value of their product rather than to the amount of time they worked to produce it. In addition to the fact that the department never received the consultant's report, staff in the Legal Division said that some of the delays in processing the companies' applications were caused because legal staff were redirected from their regular activities to assist the consultant in conducting the study.

The Financial Analysis Bureau also had a substantial number of vacancies during the period of our review. From August 1984 through August 1985, at least 5 (31 percent) of 16 authorized examiner positions were vacant, and from August 1985 through July 1986, at least 2 (13 percent) of 16 authorized examiner positions were vacant.

The lengthy vacancies in the Financial Analysis Bureau began when the division received seven new examiner positions in July 1984. According to the personnel officer, because the department had difficulty finding qualified people for these positions from its existing list of examiner candidates, the personnel office had to create a new list that took one year to develop. Furthermore, when the new positions were filled, they were intentionally filled in phases

rather than all at once. According to the chief and the supervising examiner of the Financial Analysis Division, the division could not assimilate all of the new employees at once because then all of the existing staff would have been busy training the new employees. Additionally, according to the supervising examiner, new staff cannot immediately replace experienced examiners who have left. The supervising examiner estimates that it takes a new examiner at least one and one-half years to reach the level of efficiency necessary to review complex applications.

As of December 1986, the Corporate Affairs Bureau had filled all of its authorized positions, and the Financial Analysis Bureau had filled all but one examiner position. The chiefs of both the Legal Division and the Financial Analysis Division stated that their current authorized staffing levels may be sufficient to handle their workloads as long as trained staff remain in the positions. The chief of the Legal Division added that it is difficult to tell whether the authorized level is sufficient since most of the time the division has not been staffed to the authorized level. If the Corporate Affairs Bureau or the Financial Analysis Bureau did need more staff, the department could recapture some of the cost of the additional staff by increasing the fees charged to insurance companies for the department's services.

Backlog of Applications

Another reason for the delays is that the number of applications submitted each year increased from an average of approximately 50 per year from July 1976 through June 1979 to over 200 per year in 1982. This increase, combined with the decrease in the number of staff, created a backlog. Although the number of applications received each year had dropped to approximately 60 by 1986, the department is still processing the backlog.

Application Processing Is a Low Priority

Finally, delays are also caused because the department does not consider the processing of applications its highest priority. In addition to processing companies' applications, the Corporate Affairs Bureau and the Financial Analysis Bureau monitor the legal and financial matters of companies already doing business in California. According to the assistant chief counsel of the Legal Division, to protect consumers with existing policies, the department gives higher priority to companies already authorized to do business in the State. In addition, the department was able to provide examples of several applications that it gave priority to and processed expeditiously because the department believed these applications met a market need.

CONCLUSION

The Department of Insurance has been slow in processing applications from companies seeking to do business in California. In the Corporate Affairs Bureau, for 13 (65 percent) of 20 applications we reviewed, the department was the cause for exceeding the 30-day goal in responding to an application. The delays ranged from 13 days to almost 3 years. Four of the 20 applications were delayed in the Financial Analysis Division for periods ranging from 20 days to approximately 8 months. As a result, these companies had to wait unnecessarily to enter the California marketplace. Such unnecessary waits can restrict competition within the insurance industry and limit the availability of insurance to consumers.

The delays in processing applications were caused primarily by a shortage of staff in both the Corporate Affairs Bureau and the Financial Analysis Bureau. However, as of December 1986, the department had filled most of these vacancies. In addition, a backlog of applications, which developed because the number of applications submitted each year increased substantially between 1976 and 1982, contributed to the delays. Further, the department delayed processing applications partially because it does not consider processing

applications as high a priority as its other work monitoring the legal and financial matters of the companies already licensed in California.

RECOMMENDATIONS

To ensure that it will be able to promptly process applications from insurance companies applying for authority to enter the California marketplace, the Department of Insurance should take the following actions:

- As soon as authorized positions are vacated, take steps to fill these positions;

- If authorized staffing levels prove to be insufficient to effectively manage the workload, determine the number of positions needed and undertake appropriate actions to obtain the needed positions;

- If additional positions are needed, take appropriate steps to reflect the cost of the new positions in the fees charged to insurance companies for the department's services; and

- Attempt again to obtain a report on the reorganization of the Legal Division from the consultant hired as a temporary employee.

Additionally, to ensure that the department has sufficient recourse to obtain a work product from temporary consultants, the department should, whenever appropriate, hire such consultants as contractors rather than as department employees.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code and according to generally accepted governmental auditing standards. We limited our review to those areas specified in the audit scope section of this report.

Respectfully submitted,

Thomas W. Hayes

THOMAS W. HAYES
Auditor General

Date: June 29, 1987

Staff: Robert E. Christophel, Audit Manager
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FINANCIAL POSITION OF THE PROPERTY/CASUALTY INSURANCE INDUSTRY

In recent years, consumers have had difficulty obtaining property/casualty insurance. The liability category of property/casualty insurance has been particularly difficult to obtain and afford. According to the National Conference of State Legislatures, during 1986, at least 41 states proposed legislation to resolve these problems.

Although the property/casualty industry has experienced losses in insuring risks in 10 years of the 12-year period from 1975 through 1986, it has generally compensated for these losses through its income from investing premium payments from policyholders. Specifically, when the amount of investment income realized by the property/casualty industry is combined with its losses from insuring risks during the 12-year period from 1975 through 1986, the property/casualty industry nationwide experienced overall losses in only 1984 and 1985. In 1986, the property/casualty industry nationwide realized an overall profit of approximately $6.8 billion. The experience of the property/casualty industry in California from 1975 through 1986 has been similar to the national experience.

Definition of Terms Used by the Property/Casualty Industry

Companies in the property/casualty industry have three primary sources of funds. Loss and loss adjustment expense (LAE) reserves, which are the largest source of funds available, come from premium payments from policyholders. Companies set aside these reserves to pay claims from policyholders (losses) as well as to pay expenses associated with these claims (loss adjustment expenses). Examples of loss adjustment expenses include legal fees and fees paid to claims adjusters and investigators. Companies in the property/casualty industry include in these reserves amounts for the following types of losses:

- Losses from claims that have been made by and settled with policyholders but that have not yet been paid by the company;

- Losses from claims that have been made by policyholders but that have not yet been settled; and

- Losses due to incidents that have occurred but for which a claim has not yet been filed by the policyholder. Reserves for these losses are referred to as reserves for incurred but not reported (IBNR) losses.

The policyholders' surplus, which is a second source of funds available to an insurance company, provides extra resources for the company in case of catastrophic, unexpected losses and also provides working capital for company expansion. Every insurance company is required to have a minimum amount in its policyholders' surplus before it can be granted a license in the state in which it intends to establish its headquarters. For a stock insurance company, the funds that constitute the policyholders' surplus come from the money that stockholders pay for company stock. For a mutual insurance company, which is owned by the policyholders themselves, the funds that constitute the surplus come from money that policyholders loan or pay into the company to create the surplus.

The third source of funds available to an insurance company comes from operating profit, which is the sum of the underwriting income and the investment income realized by an insurance company. Underwriting income is the income from the business of providing insurance coverage to policyholders and is defined as total premiums minus losses and LAE and underwriting expenses. Examples of underwriting expenses include commissions, salaries, rent, and postage. Investment income, which results when an insurance company invests its reserves and policyholders' surplus, comprises the interest, dividends, and other amounts received from a company's continuing investments, less investment expenses.

Financial Position of the Property/Casualty Industry in Recent Years

As the graphs that follow illustrate, the operating profit of the property/casualty industry nationwide has not fluctuated greatly since 1975, but both the loss and LAE reserves and policyholders' surplus have continued to rise.* Specifically, as Graph 1 illustrates, during 1984 and 1985, when operating profit was negative and the insurance "crisis" was a major topic in the news, the industry still received enough funds from its operations to increase both loss and LAE reserves and policyholders' surplus. Graph 1 also shows that there was an upsurge in industry operating profit from 1985 to 1986, and that, in 1986, industry operating profit, at $6.8 billion, was at its highest level since 1981.

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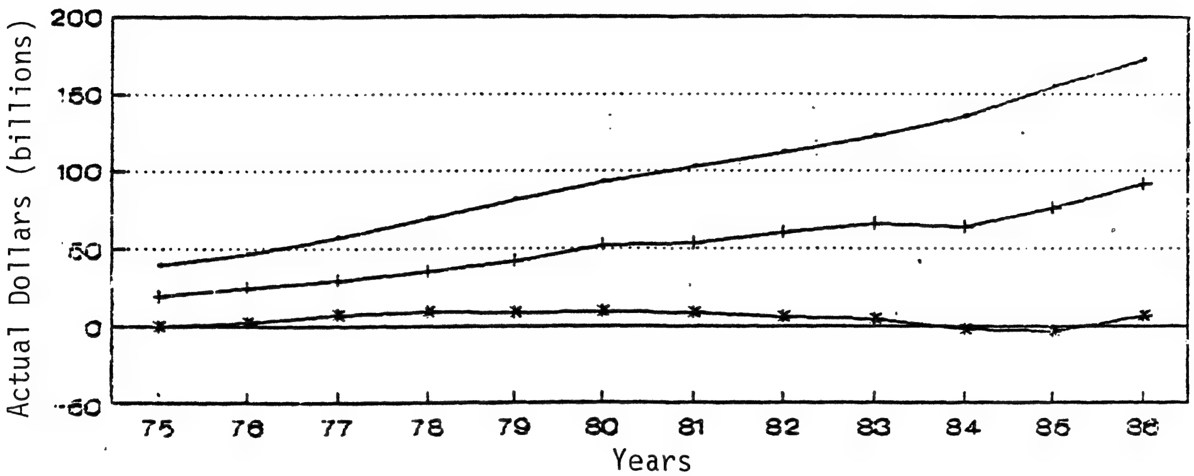
*Our sources were Best's Aggregates and Averages, Property/Casualty Edition for Graphs 1, 1A, 2, 3, 3A, 5 and 6; Best's Insurance Management Reports for Graphs 1, 1A, 2, and 3; and the Underwriters' Report and Best's Executive Data Service, Property/Casualty Edition for Graph 4. In addition, for all the graphs, we compared information from the 1985 annual statements of the 20 largest insurance companies in California with the data in Best's Insurance Reports and the Underwriters' Report and found no discrepancies. The figures for 1986 were estimated by Best's.

GRAPH 1

**PROPERTY/CASUALTY INDUSTRY NATIONWIDE
LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES,
POLICYHOLDERS' SURPLUS, AND OPERATING PROFIT
1975 - 1986**

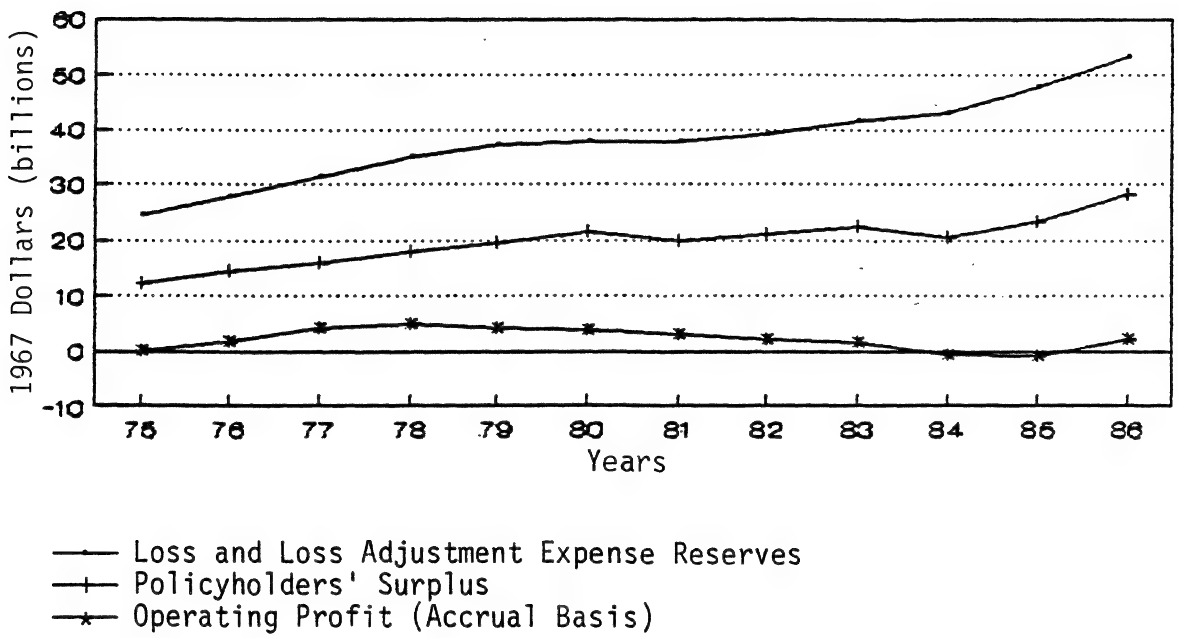


Loss and Loss Adjustment Expense Reserves
Policyholders' Surplus
Operating Profit (Accrual Basis)

Graph 1A presents the same components as Graph 1, but they have been adjusted to account for inflation. We used 1967 as the base year because that is the year used by the federal government to develop the Consumer Price Index.

GRAPH 1A

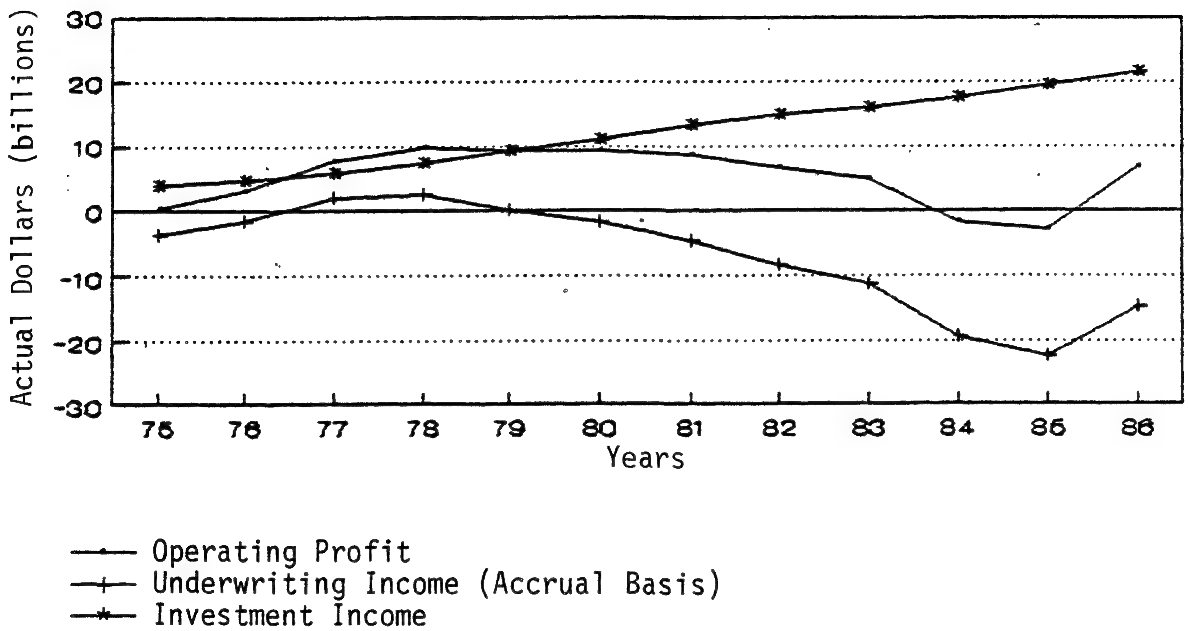
PROPERTY/CASUALTY INDUSTRY NATIONWIDE
LOSS AND LOSS ADJUSTMENT EXPENSE RESERVES,
POLICYHOLDERS' SURPLUS, AND OPERATING PROFIT
ADJUSTED TO ACCOUNT FOR INFLATION
1975 - 1986



As Graph 2 illustrates, the two components of operating profit--underwriting income and investment income--have generally moved in opposite directions since 1978. While industry underwriting income has generally decreased since 1975, industry investment income has continued to increase by an amount sufficient to maintain an overall operating profit in all years except 1984 and 1985.

GRAPH 2

PROPERTY/CASUALTY INDUSTRY NATIONWIDE OPERATING PROFIT AND ITS COMPONENTS 1975 - 1986



One characteristic of the insurance industry that helps to explain the trade-off between underwriting income and investment income is that when investment opportunities are relatively good, insurance companies typically underprice insurance coverage to obtain larger amounts of premiums from policyholders. The companies invest these premiums to take advantage of investment opportunities. This underpricing occurred from 1980 to 1984, when interest rates on investments were high. In 1984, when interest rates began to decline, the insurance industry was unable to sustain an operating profit because it had underpriced insurance coverage. The operating losses experienced by the industry in 1984 and 1985 were a result of this period of underpricing.

As Graph 2 shows, the underwriting losses experienced by the insurance industry in 1984 and 1985 contributed to the operating losses that occurred in the industry in those years. However, underwriting income can be calculated in two ways, on an accrual basis or a cash basis. Several studies, including those conducted by the United States General Accounting Office, the California Trial Lawyers Association, and the special counsel to the California attorney general, have noted that different amounts of underwriting income can be calculated, depending upon which basis is used. (Unless otherwise indicated, all underwriting income figures mentioned in this report are calculated on an accrual basis.)

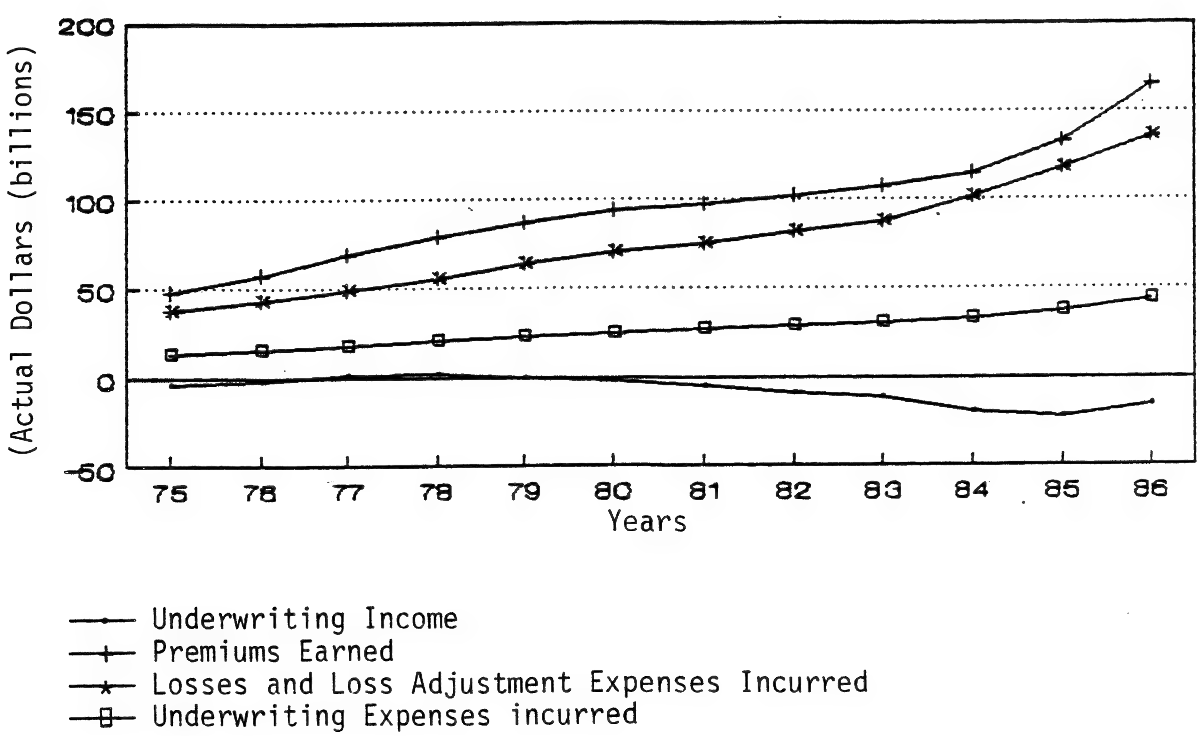
Graph 3 shows underwriting income since 1975 on an accrual basis, as the industry reports it, and illustrates the increases in all of the components of underwriting income. On an accrual basis, the underwriting income is calculated in the following way:

Underwriting Income (accrual basis)	=	Premiums Earned	minus	Losses & LAE Incurred	minus	Underwriting Expenses Incurred

The losses and expenses are incurred when the company sets aside a reserve for the payment of claims. The premium is earned on a prorated basis over the term of the insurance policy. As Graph 3 illustrates, underwriting income on an accrual basis was at its lowest points in 1984 and 1985 but rose somewhat in 1986.

GRAPH 3

PROPERTY/CASUALTY INDUSTRY NATIONWIDE UNDERWRITING INCOME - ACCRUAL BASIS 1975 - 1986



Although Graph 3 shows that underwriting income was negative for 10 of the 12 years since 1975, the industry's underwriting income would be different if the income were calculated on a cash basis. Underwriting income can be calculated on a cash basis in the following way:

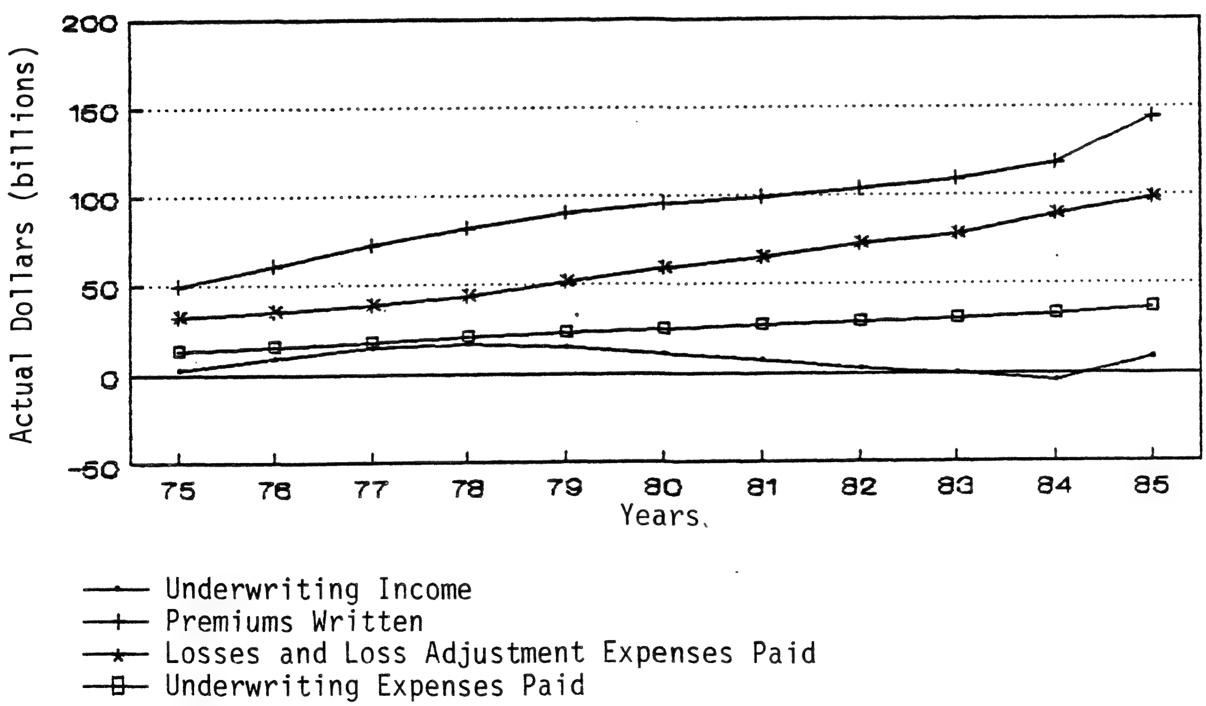
Underwriting Income (cash basis)	=	Premiums Written	minus	Losses & LAE Paid	minus	Underwriting Expenses Paid

The premiums are written when the company receives the premium payments from the policyholder.

Graph 3A, showing underwriting income on a cash basis, illustrates an economic situation vastly different from the calculation of underwriting income on an accrual basis.

GRAPH 3A

PROPERTY/CASUALTY INDUSTRY NATIONWIDE
UNDERWRITING INCOME - CASH BASIS
1975 - 1985



As Graph 3A shows, underwriting income calculated on a cash basis since 1975 was negative in only one year, as opposed to the ten years of negative underwriting income calculated on an accrual basis. Furthermore, if overall profit is calculated on a cash basis, the

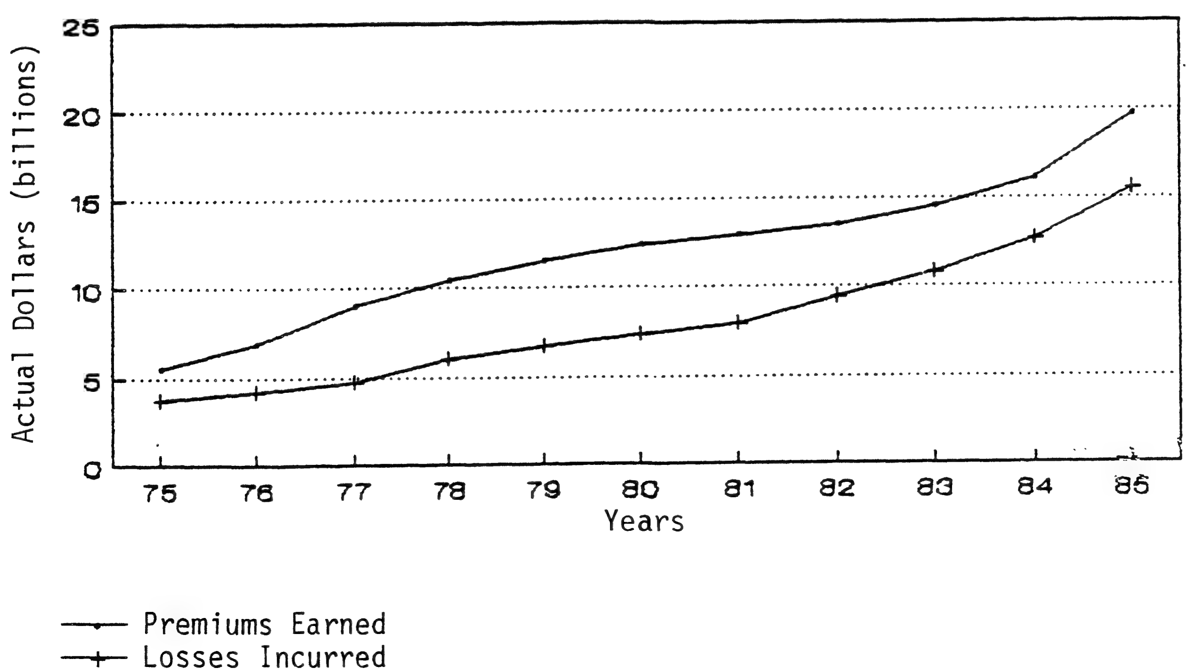
industry shows no losses at any point from 1975 to 1985. In contrast, when calculated on an accrual basis, the industry shows overall losses in two years, 1984 and 1985.

However, according to the chief property/casualty actuary for the Department of Insurance, the industry claims that the calculation of underwriting income on an accrual basis provides a more realistic matching of the inflows and outflows of its funds over time. In addition, underwriting income calculated on a cash basis will be greater than underwriting income calculated on an accrual basis during periods of inflation or during periods of company expansion. The reason for this is that when inflation occurs or when the industry grows larger, incurred losses will exceed losses paid because the incurred losses will include additional amounts for expected future inflation and for an increased number of future claims due to industry expansion.

The underwriting experience of the property/casualty industry in California since 1975 has been similar to the national experience. Graph 4, which shows premiums earned and losses incurred in California only, illustrates that the trends in California are similar to the national trends, which are illustrated in Graph 3.

GRAPH 4

PROPERTY/CASUALTY INDUSTRY IN CALIFORNIA
PREMIUMS EARNED AND LOSSES INCURRED
1975 - 1985



Recent Controversy in the Liability and Nonliability Industries

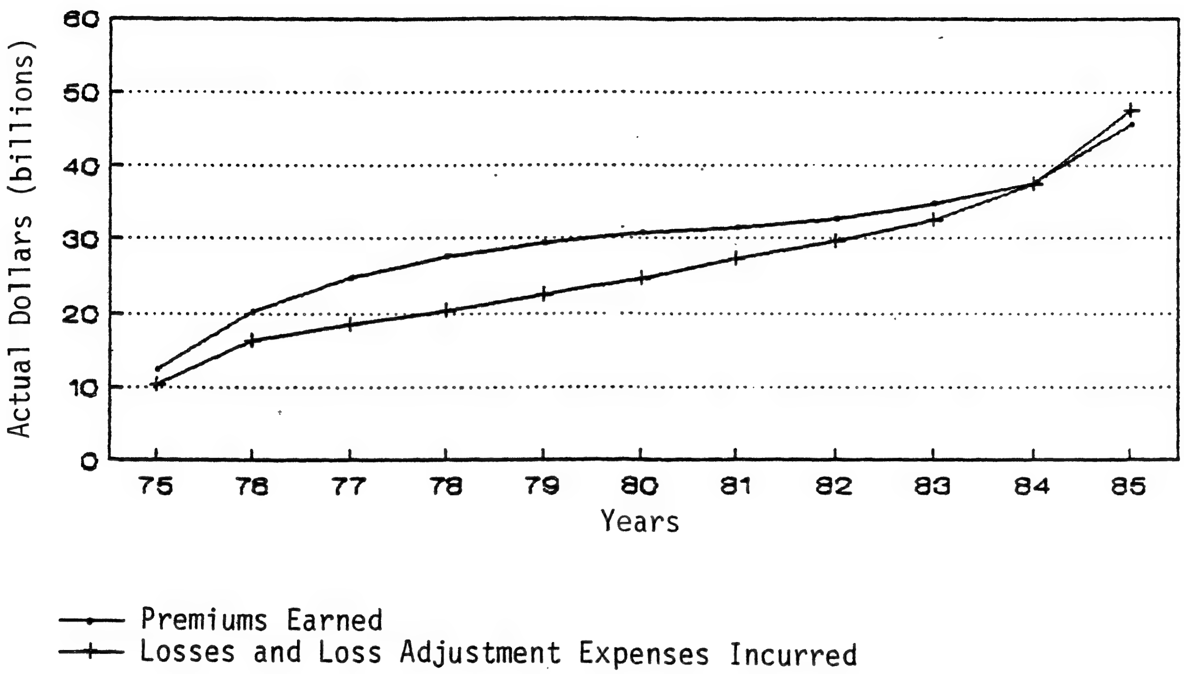
The property/casualty industry has cited an unprecedented number of lawsuits and large jury awards in recent years as two of the reasons why liability insurance has been difficult to obtain and afford. Other organizations have denied this explanation. For example, in a report in 1986, the special counsel to the California attorney general came to the following conclusion:

> ...a long-term trend toward more tort lawsuits, toward increased liability for damages...and toward larger jury verdicts for the most seriously injured plaintiffs...[has] been established for decades, and there is no evidence...to believe that the trends have accelerated in recent years. And there is no reason to believe that the sharp increases in insurance premiums and crisis in availability have been caused by any recent change in those trends.

Graphs 5 and 6 illustrate the trends in premiums earned and losses and LAE incurred in the liability and nonliability insurance categories since 1975. We classified as part of the liability category only those lines of property/casualty insurance that primarily provide liability insurance, which consists of medical malpractice, private passenger auto liability, commercial auto liability, and "other" liability. All remaining lines within the property/casualty industry, such as allied lines and group accident and health, were classified as part of the nonliability category.

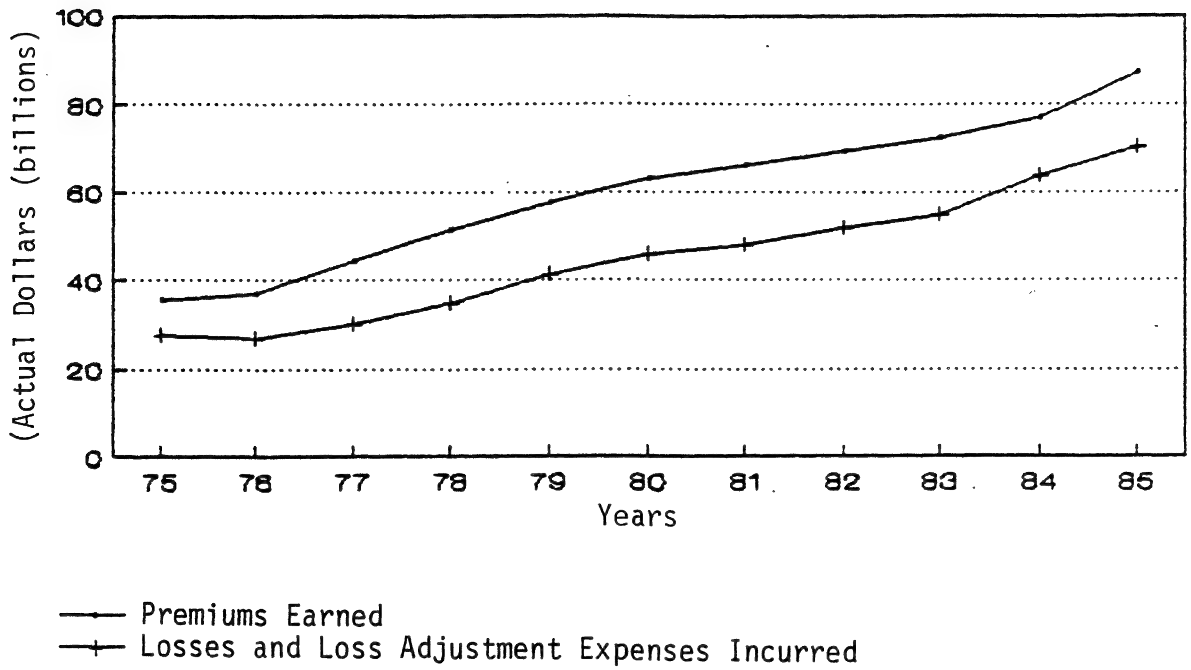
GRAPH 5

LIABILITY INSURANCE NATIONWIDE
PREMIUMS EARNED AND LOSSES AND LOSS ADJUSTMENT EXPENSES INCURRED
1975 - 1985



GRAPH 6

NONLIABILITY INSURANCE NATIONWIDE
PREMIUMS EARNED AND LOSSES AND LOSS ADJUSTMENT EXPENSES INCURRED
1975 - 1985



As Graphs 5 and 6 illustrate, the trends in the premiums earned and losses and LAE incurred since 1975 have, for the most part, been similar for both the liability and nonliability categories. However, these graphs indicate that the differences between losses and LAE and premiums earned have been smaller in the liability category than in the nonliability category. Some of this difference is explained by the nature of liability insurance. For example, it takes longer to settle and pay claims in the liability lines than it does to settle and pay claims in the other lines of the property/casualty industry. Because of this fact, liability insurance companies hold premium payments from their policyholders for a longer time than do other types of insurance companies. Additionally, because liability insurance companies will have the premiums longer, they will realize greater investment income from them. Recognizing this, insurance companies price liability insurance lower in relation to its expected payouts than nonliability insurance in relation to its expected payouts. This practice partially explains why there is a smaller difference between losses and LAE incurred and premiums earned in the liability category than in the nonliability category.

Property/Casualty Industry Tax Advantages

To more fully understand the financial position of the property/casualty industry, it is useful to be aware of certain accounting practices used by the industry, some of which provide it with tax advantages. For example, for income tax purposes, as noted by the special counsel to the California attorney general, companies in the property/casualty industry deduct from their income the amount of reserves that they set aside to pay both current and future claims from policyholders. They do not deduct the actual amount for claims paid to policyholders in the tax year. Additionally, when insurance companies establish these reserves, they do not discount them to account for the time value of money. As noted by the United States General Accounting Office, if loss reserves were discounted by the industry, the size of the reserves would be reduced and, as a result, companies within the industry would show a greater amount of taxable income.

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Office of Traffic Safety

BUSINESS, TRANSPORTATION AND HOUSING AGENCY

June 19, 1987

Mr. Thomas W. Hayes
Auditor General
660 J Street, Suite 300
Sacramento, CA 95814

Dear ~~Mr. Hayes~~: Tom

Thank you for the opportunity to review your draft report entitled "The Department of Insurance Needs to Further Improve and Increase Its Regulatory Efforts."

Both the Department and I were pleased to note your office has recognized the recent improvements in its rate regulation examination procedures. Further improvements will result as your recommendations and others are put in place.

I would like to respond to the report's recommendtions in its two principal sections.

I. THE DEPARTMENT OF INSURANCE NEEDS TO FURTHER IMPROVE ITS RATE EXAMINATION PROCEDURES

Recommendation

Conduct more frequent multiline rate examinations.

Response

The Field Operations Bureau has taken steps to expedite the rating and underwriting examinations. Experienced people have been hired, personnel have received training resulting in reduction of size of examination teams. Continued dispersement of personnel will greatly enhance the number of examinations conducted.

Recommendation

Ensure that existing staff is sufficient to obtain goals.

Response

The Department has already increased the number of analysts conducting examinations to 23. This will make it possible to examine the number of companies required to adequately regulate rates adopted for California use on a five-year cycle.

Recommendation

Take more formal disciplinary action against companies.

Response

As part of our follow-up examination procedure, the steps outlined in Sections 1958.1 and 1858.2 of the California Insurance Code will be initiated whenever necessary to achieve compliance with the rating law.

Recommendation

Set standard for frequency of examinations.

Response

The Field Operations Bureau has established a standard whereby each insurer producing a significant volume of California business will be examined at no more than five year intervals. This includes those companies producing significant premiums as well as those determined to have specific problems with their rating or underwriting plans.

Recommendation

Establish a procedure requiring examiners to note in the examination reports whether similar deficiencies were cited in prior examinations.

Response

All Field Operations Bureau analysts are aware of the requirement that a follow-up examination be conducted if recurring criticisms are found. They have also been instructed to suggest follow-up examinations whenever a practice that may have a significant impact on consumers is criticized.

To ensure consistency, a memorandum will be issued to all rate analysts re-emphasizing the Department's position regarding follow-up examinations.

Recommendation

Establish a policy regarding use of disciplinary actions.

Response

It is, and always has been, the policy of the Department to proceed under Sections 1858.1 and 1858.2 of the California Insurance Code whenever the California rating law is violated and compliance cannot be achieved voluntarily.

II. THE DEPARTMENT OF INSURANCE HAS BEEN SLOW TO PROCESS APLICATIONS FROM COMPANIES SEEKING TO DO BUSINESS IN CALIFORNIA

Recommendation

As soon as authorized positions are vacated, take steps to fill these positions.

Response

The Department will continue to strive to fill positions with qualified employees.

Recommendation

If authorized staffing levels prove to be insufficient to effectively manage the workload, determine the number of positions needed and undertake appropriate actions to obtain the needed positions.

Response

The Business, Transportation and Housing Agency and the Department of Finance are currently reviewing staffing needs of the Department.

Recommendation

If additional positions are needed, take appropriate steps to reflect the cost of the new positions in the fees charged to insurance companies for Department services.

Response

The Department is supported by a special fund from fees collected from the industry. As expenditures grow fees are increased.

Recommendation

Attempt again to obtain a report on the reorganization of the Legal Division from the consultant hired as a temporary employees.

Response

The Department is doing this.

The Department has expressed several concerns to me regarding conclusions contained in the report. They will contact your staff and discuss those concerns.

Again, thank you for the opportunity to review your draft report.

Sincerely,

John

JOHN K. GEOGHEGAN
Secretary

cc: Members of the Legislature
Office of the Governor
Office of the Lieutenant Governor
State Controller
Legislative Analyst
Assembly Office of Research
Senate Office of Research
Assembly Majority/Minority Consultants
Senate Majority/Minority Consultants
Capitol Press Corps